



DEFENSE CONTRACT AUDIT AGENCY
AUDIT REPORT NO. 3311-2004K21000012



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PREPARED FOR: Procuring Contracting Officer
U.S. Army Corps of Engineers
Fort Worth District
ATTN: Vernon Vann, Contract Specialist
819 Taylor Street, Room 2A19
Fort Worth, Texas 76102

PREPARED BY: DCAA Arlington Branch Office
Kellogg Brown & Root Suboffice
4100 Clinton Drive, Building 1, Room B-2
Houston, Texas 77020-6237
Telephone No. (713) 753-2167
FAX No. (713) 753-2919
E-mail Address dcaa-fao3318@dcaa.mil

SUBJECT: Report on Audit of Proposal for Restore Iraqi Oil Task Order No. 10

REFERENCES: Prime Contract No. DACA63-03-D-0005, Task Order No. 10
Relevant Dates: See Page 27

CONTRACTOR: Kellogg Brown & Root Services, Inc.
A Division of Kellogg Brown & Root, Inc.
4100 Clinton Drive
Houston, Texas 77020-6237

REPORT RELEASE RESTRICTIONS: See Page 28

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SUBJECT OF AUDIT

As requested by the U.S. Army Corps of Engineers (COE), on March 30, 2004, we examined the Kellogg Brown & Root Services, Inc.'s (KBR) Cost-Plus-Award-Fee task order (TO) 10 proposal, dated March 26, 2004, under the Restore Iraqi Oil (RIO) contract to determine if the proposed costs are acceptable as a basis to negotiate a fair and reasonable TO price. The \$30,000,000 proposal was submitted in response to the Notice to Proceed issued on March 19, 2004 and is for the import and distribution of fuel products in order to meet the domestic need for fuels for commercial and private use within Iraq. The company proposed a period of performance (POP) of 11 days or until funds are expended, whichever occurs first.

KBR's proposed costs are subject to cost and pricing data. In contrast, the proposed costs for the Kuwait supplier, Altanmia, were subject of a cost and pricing waiver granted by the Commanding General, COE, on December 19, 2003. As requested by Mr. Gordon Sumner, Director, Directorate of Contracting, COE, Southwestern Division on August 3, 2004, we evaluated the reasonableness of the refined fuels and related transportation from Kuwait that were subject to the waiver of the requirement to submit cost or pricing data. Refer to page 12 for additional comments regarding the waiver.

The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposal based on our examination.

EXECUTIVE SUMMARY

The proposal as submitted is not acceptable for negotiation of a fair and reasonable price; however, in an effort to meet the needs of the contracting officer, we evaluated the proposal to the extent possible under the circumstances and gathered data to support a negotiation position. Our examination of the \$30,000,000 proposal disclosed [REDACTED] of questioned costs. Our questioned costs are primarily based on reasonableness. In our opinion, KBR did not provide adequate evidence to substantiate the reasonableness of proposed Kuwait fuel prices as described below. Moreover, KBR did not take appropriate action to negotiate better pricing for the fuel and transportation costs.

SIGNIFICANT ISSUES:

1. The results of audit are qualified because we have not received the requested technical review of the proposed number and need for tanker trucks, Liquefied Petroleum Gas (LPG) barges, quantity of fuel, and a statement there was, or was, not a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait.
2. The primary reasons for questioned material and subcontract costs are discussed below:
 - a. Proposed costs for the fuels procured from a Kuwait supplier (Altanmia) are based on May 2003 purchase orders negotiated in a very short time frame. [REDACTED]

[REDACTED] We recognize the challenges faced by KBR

during the early stages of the war; however, KBR did not update its purchase order files to document the reasonableness of the negotiated prices and the circumstances surrounding the purchase order awards, within a reasonable period of time (e.g. initial purchase order issued May 2003 and Notice to Proceed on TO 10 issued March 19, 2004). Effective subcontract administration of purchase order files requires ongoing (e.g. monthly) documented reviews of the continued reasonableness of the Kuwait fuel prices and efforts to renegotiate these prices if such reviews indicated unreasonable prices. [REDACTED]

[REDACTED] We only found two instances where KBR renegotiated some of the prices. In November 2003 and January 2004, KBR negotiated some reductions to the pricing for the Kuwait fuel transportation costs. However, KBR's purchase order files do not include documentation to demonstrate these updated transportation prices were fair and reasonable. [REDACTED]

In the absence of adequate supporting data, we explored alternative methods to evaluate the reasonableness of the Kuwait fuel prices. We found the Defense Energy Support Center (DESC) awarded purchase orders in March 2004 to Altanmia for transportation and the KPC for unleaded fuel and diesel. We used the DESC negotiated prices as a benchmark to assess reasonableness of the proposed KBR costs and questioned [REDACTED]. Refer to Note 5, page 10 for further details.

b. KBR proposed costs for kerosene and transportation after it was directed by the Administrative Contracting Officer (ACO) to stop all kerosene imports from Kuwait no later than March 18, 2004. The TO 10 proposal includes [REDACTED] of proposed costs for kerosene after the stop notice. Refer to Note 5, page 10 for further details.

c. We question the entire costs proposed for "subcontractor claims" and "demurrage costs" which totals [REDACTED]. KBR did not provide a breakout of these costs between what was proposed as "subcontractor claims" and "demurrage" costs. Based on our review of the data presented by KBR, we determined all of the demurrage costs incurred by KBR were incurred under TOs 5 and 7. As a result, demurrage costs should not be proposed under TO 10. Since KBR has not been able to identify or support proposed "subcontractor claims" costs, we question these costs as they represent contingencies which "should be excluded from cost estimates" in accordance with FAR 31.205-7 (c) (2). KBR did not separately identify these costs and the basis of estimate as required by FAR. Refer to Note 5, page 16 for further details.

d. We question [REDACTED] of proposed subcontractor DBA insurance. Although DBA insurance is a requirement resulting from the Defense Base Insurance Act, we question these costs because (i) KBR did not provide any support for amounts proposed for subcontractors, and (ii) we would expect such costs would have already been included in subcontractor estimates. Absent any support to the contrary, it appears the proposed costs duplicate costs already included in negotiated subcontracts. Refer to Note 6, page 17 for further details.

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3. As of July 31, 2004, recorded direct costs on TO 10 are less than the proposed costs by [REDACTED]. Specifically, KBR proposed direct costs of [REDACTED] while [REDACTED] was charged to the RIO 10 Job Cost Ledger as of July 31, 2004. KBR's proposal does not include any recorded costs. KBR is currently analyzing the validity of all RIO transactions and expects to make significant adjustments to all RIO TOs upon completion of their analysis. Any analysis and consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information. Refer to pages 4 and 5 for further details.

SCOPE OF AUDIT

Except for the qualification described below, we conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance that the proposal is free of material misstatement. An examination includes:

- evaluating the contractor's internal controls, assessing control risk, and determining the extent of audit testing needed based on the control risk assessment;
- examining, on a test basis, evidence supporting the amounts and disclosures in the proposal;
- assessing the accounting principles used and significant estimates made by the contractor;
- evaluating the overall proposal presentation; and
- determining the need for technical specialist assistance.

We evaluated the proposed costs using the applicable requirements contained in the:

- Federal Acquisition Regulation (FAR),
- Defense FAR Supplement (DFARS), and
- Cost Accounting Standards.

[REDACTED]

[REDACTED]

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The scope of our examination reflects our assessment of control risk and includes audit tests designed to provide a reasonable basis for our opinion.

QUALIFICATION

On April 2, 2004, we requested a technical evaluation from the COE to determine the reasonableness of the number and need for tanker trucks and LPG barges, the quantity of fuel, and a statement determining whether or not there was sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait. On April 14, 2004, Mr. Vernon D. Vann, Contract Specialist, informed us a technical evaluation would not be provided to us. We consider the technical analysis to be essential for our results of audit. Accordingly, the audit results are qualified to the extent additional costs could have been questioned based on a technical evaluation.

RESULTS OF AUDIT

In our opinion, except for the qualification discussed above, the cost or pricing data submitted by the offeror are inadequate in part (see comments on Exhibit A, Notes 2, and 6 respectively for labor and other direct costs). However, the inadequacies described are considered to have limited impact on the subject proposal. The other than cost or pricing data submitted by the offeror are not adequate (see comments on Exhibit A, Note 5 for Kuwait fuel and transportation costs).

[REDACTED]

[REDACTED] we evaluated the proposal to the extent possible under the circumstances and gathered data to support a negotiation position. However, the technical evaluation described above is significant enough to materially impact the results of audit. Therefore, as discussed with Mr. Vann by Stephanie Casey, Auditor, on April 2, 2004, we recommend that contract price negotiations not be concluded until the results of the technical evaluation are considered by the contracting officer.

Recorded Costs

As of July 31, 2004, recorded direct costs on TO 10 are less than the proposed costs by [REDACTED]. Specifically, KBR proposed direct costs of [REDACTED] while [REDACTED] was charged to the RIO 10 Job Cost Ledger as of July 31, 2004. KBR's proposal does not include any recorded costs. [REDACTED]

[REDACTED] Any analysis and consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information.

As part of our accounting system review, KBR disclosed it was in the process of performing a detailed analysis of RIO transactions, particularly fuel related transactions. [REDACTED]

Since KBR has not reflected all adjustments in its official books and records, we are unable to perform our review of the correcting entries. KBR plans to complete its analysis and processing the adjusting journal vouchers in the near future. Our office plans to review adjusting entries when KBR's adjustments are completed.

Proposed Costs

Our examination of the \$30,000,000 proposal disclosed [REDACTED] in questioned costs as summarized below.

EXHIBIT A

Contractor's Proposal & Results of Audit Review				
Cost Element	Proposed	Questioned Costs	Difference (Note 1)	Notes
Direct Costs				
Labor	[REDACTED]	[REDACTED]	[REDACTED]	2
Other Labor Related Cost (OLRC)	[REDACTED]	[REDACTED]	[REDACTED]	3
Equipment	[REDACTED]	[REDACTED]	[REDACTED]	4
Material	[REDACTED]	[REDACTED]	[REDACTED]	5
Subcontract	[REDACTED]	[REDACTED]	[REDACTED]	5
Other Direct Cost (ODC)	[REDACTED]	[REDACTED]	[REDACTED]	6
Subtotal of Direct Costs	[REDACTED]	[REDACTED]	[REDACTED]	
Overhead	[REDACTED]	[REDACTED]	[REDACTED]	7
Subtotal	[REDACTED]	[REDACTED]	[REDACTED]	
G&A	[REDACTED]	[REDACTED]	[REDACTED]	8
Facilities Capital Cost of Money	[REDACTED]	[REDACTED]	[REDACTED]	9
Total Costs	[REDACTED]	[REDACTED]	[REDACTED]	
Base Fee @ 2%	[REDACTED]			
Award Fee @ 5%	[REDACTED]			
Rounding	[REDACTED]			
Total Costs & Fee	<u>\$ 30,000,000</u>			

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Explanatory Notes

1. The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiation objective. They represent only the arithmetic difference between the amounts proposed and questioned costs. You should not consider the amounts to be audit approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters.

2. Labor

a. Summary of Conclusions:

We questioned [REDACTED] of labor costs primarily due to KBR proposing Rest & Relaxation (R&R) labor costs, when none should be allowed under KBR's employment agreements, and area differential and danger pay in excess of Department of State Standardized Regulations (DSSR), as of January 2004. Questioned costs are summarized as follows:

	Questioned Costs
Area Differential & Danger Pay	[REDACTED]
Home Office Support	[REDACTED]
R&R Labor	[REDACTED]

b. Basis of Contractor's Cost:

Labor hour calculations for the proposed employees are based on management estimates. [REDACTED]

[REDACTED]. In addition to basic pay, employees receive premiums such as foreign service bonus, area differential, and danger pay based on their locations. KBR proposed area differential and danger pay rates of [REDACTED] percent for Kuwait. [REDACTED]

Labor rates used in this proposal are the actual labor rates presented by KBR; [REDACTED]

The Home Office Support rate is based on an average of employee rates that perform jobs under these job classifications. KBR stated the rates are within the company's established salary grade range for the positions and are in line with pay rates of other employees performing like functions in support of this contract.

R&R is based on [REDACTED] employment agreements which states "employees are eligible for 14 days paid leave and travel after working 12 weeks at site."

c. Audit Evaluation:

[REDACTED]

We questioned [REDACTED] of area differential and danger pay which is in excess of the January 2004 Department of State Standardized Regulations (DSSR) for area differential and danger pay. KBR proposed [REDACTED] percent for area differential and danger pay for Kuwait. According to the DSSR, as of January 2004, area differential and danger pay for Kuwait is 15 percent of employees' base pay. In addition, we questioned [REDACTED] of labor costs because the actual Home Office Support rate is lower than the proposed rates.

We questioned [REDACTED] in R&R labor costs because KBR proposed R&R which should not be allowed per its employment agreements. KBR's employment agreement is specific for the RIO contract and states, "Rotational Leave will not be approved unless the job assignment is expected to last for a period of at least one month beyond the qualification date." The period of performance for TO 10 is March 19, 2004 through March 29, 2004 (Notice to Proceed date of March 19, 2004 with an estimated 11 days POP). KBR's contractual duty on the entire RIO contract ended March 31, 2004, 2 days after the estimated period of performance. With the contract ending and only 2 days in the POP, there is no opportunity for employees' job assignments to last for a period of at least one month beyond the R&R qualification date; therefore, we questioned the labor costs associated with R&R.

d. Contractor's Reaction:

KBR did not provide any comments concerning factual matters regarding area differential and danger pay and labor rates. KBR representatives indicated employees eligible for R&R should be allowed to take it. However, KBR did not provide comments to justify proposing R&R for employees that will not be able to work one month on the RIO contract after return from R&R pursuant to KBR's employment agreement for the RIO contract.

e. Auditor's Response:

Based on the employment agreement, R&R cannot be taken unless there is one month remaining on the contract. The employee agreement is contract specific. Therefore, under the RIO contract which ended March 31, 2004, there is not enough time to work one month after returning from R&R. If the employee's job assignment overseas continues under another contract, then the R&R charges should be charged to the other contract not to the current RIO contract.

3. Other Labor Related cost (OLRC)

We compared the proposed burden and benefit rates to the Forward Pricing Recommended Rates (FPRR) dated [REDACTED] and found insignificant exceptions.

4. Equipment

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Due to the insignificance of the individual equipment costs we did not review the proposed costs.

5. Material and Subcontract Costs

a. Summary of Conclusions:

We questioned [REDACTED] of material and subcontract costs primarily due to KBR's failure to demonstrate reasonable pricing for the Kuwaiti fuel and transportation costs [REDACTED], KBR proposing costs for kerosene after the ACO's stop notice [REDACTED], and KBR proposing unallowable costs for subcontractor claims and proposing costs assignable to TOs 5 and 7 for demurrage (combined questioned costs of [REDACTED]). Proposed and questioned costs are summarized as follows:

	Proposed	Questioned
Material	[REDACTED]	[REDACTED]
Subcontracts	[REDACTED]	[REDACTED]
	[REDACTED]	[REDACTED]

b. Basis of Contractor's Cost:

The Kuwaiti proposed fuel and transportation costs are based on five purchase orders dated between August 2003 and November 2003. These purchase orders include the same pricing as the initial May 2003 purchase orders that were negotiated in a very short time frame. The Kuwaiti transportation costs are based on a monthly rental fee, independent of the number of trips, and fuel costs are based on a unit price per liter. KBR issued change orders to cover this TO. KBR did not provide the basis for estimates, including calculations, for the proposed costs for subcontractor claims and demurrage costs.

c. Audit Evaluation:

The following page contains a schedule of our evaluations of the material and subcontract costs.

<u>Material Costs</u>	<u>Proposed</u>	<u>Questioned</u>	<u>Notes</u>
Kuwait - Unleaded Gasoline			(1)
Kuwait - Diesel			(1)
Kuwait - Kerosene			(1)
Other			(2)
Total Material Costs			
Subcontract Costs			
Kuwait Transportation - Unleaded Gasoline			(1)
Kuwait Transportation - Kerosene			(1)
Kuwait Transportation - Diesel			(1)
Total Kuwait Subcontract Costs			
Total Questioned Kuwait Material & Subcontract Costs			(1)
Subcontractor Claims & Demurrage			(3)
Other			(2)
Total Subcontract Costs			
Total Material and Subcontract Costs			**

** The break-out of the total questioned costs of [REDACTED] is [REDACTED] for material costs and [REDACTED] for subcontract costs. Details of these calculations will be provided during negotiations.

(1) Kuwaiti Material & Subcontract Costs

Proposed costs for the fuels procured from a Kuwait supplier (Altanmia) are based on May 2003 purchase orders that were negotiated in a very short time frame. [REDACTED]

by KBR during the early stages of the war;

We recognize the challenges faced

We only found two instances where KBR renegotiated some of the prices. In November 2003 and January 2004, KBR negotiated some reductions to the pricing for the Kuwait fuel transportation costs [REDACTED]

We also did not find evidence KBR took action to renegotiate the fuel or transportation costs after January 25, 2004 when the KPC was willing to deal directly with KBR.

[REDACTED]

As an alternative, to determine the reasonableness of the prices, we evaluated the consent packages KBR provided to its ACO. These consent packages included a Request for Consent from KBR and a letter from the ACO granting KBR approval to enter into or extend the contract with the subcontractor. The Request for Consent included the type of subcontract, a list of previous change orders, and the process KBR used to select the subcontractor.

[REDACTED]

[REDACTED]

We found the DESC awarded purchase orders in March 2004 to Altanmia for transportation and the KPC for unleaded fuel and diesel. We used the DESC negotiated prices as a benchmark to assess reasonableness of the proposed KBR costs and questioned [REDACTED]

The following is a schedule, showing the calculations, of the questioned costs for Kuwaiti fuel and transportation:

Contract No.	Proposed Number of Units	Proposed Liter Price	Audit Recommended Liter Price*	Difference in Liter Price	Questioned Costs
Unreasonable Costs:					
RIO-JIK-PO-3129 - Unleaded Fuel	21,937,500	[REDACTED]			
RIO-JIK-PO-S0164 - Transportation		[REDACTED]			
Subtotal - Unleaded Fuel/Trans.		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
RIO-JIK-PO-2893 - Diesel	986,000	[REDACTED]			
RIO-JIK-PO-S0164 - Transportation		[REDACTED]			
Subtotal - Diesel Fuel/Trans.		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Subtotal Unreasonable Costs					[REDACTED]
Costs After ACO Stop Notice:					
Kerosene					
RIO-JIK-PO-2893	18,171,500	[REDACTED]			
RIO-JIK-S0138 - Transportation		[REDACTED]			
Subtotal		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total Questioned Costs					[REDACTED]

*Audit recommended price includes fuel and transportation costs.

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We questioned [REDACTED] of fuel and transportation costs based on the information KBR provided and information obtained from outside sources to determine the reasonableness of the proposed prices per liter. Using DESC negotiated fuel prices as a benchmark for reasonableness as discussed below, we calculated audit recommended prices per liter and questioned the difference between the proposed and our recommended prices.

[REDACTED], we have, as an alternative evaluation technique, compared the proposed prices to recently negotiated prices used by DESC. DESC has three contracts consisting of the purchase of fuel from KPC (Contract No. SP0600-04-0491), transportation services from Altanmia (Contract No. SP0600-04-D-0492), and management and oversight of the fuel operation from the Public Warehousing Company (Contract No. SP0600-04-C-5418). Below is a table summarizing the audit recommended liter prices of the fuel using prices negotiated by DESC adjusted by the Platt Pricing Index:

	Unleaded (Liter)	Diesel (Liter)	Reference
Market Adjusted Price	\$0.296	\$0.250	(a)
Transportation	0.111	0.111	(b)
Management & Oversight	0.002	0.002	(c)
Total Unit Price	<u>\$0.409</u>	<u>\$0.363</u>	

(a) Market Adjusted Price

DESC negotiated a price per liter with KPC and Altanmia in the February/March 2004 timeframe. The negotiated base fuel price is variable with market prices as indexed with the Platts Pricing Index. For every half month period the pricing is based on the previous half month period. For example, the average Platts price for March 1 through March 15, 2004 is \$0.296, per liter, for unleaded gasoline. For fuel delivered during the time period of March 16 through March 31, 2004, KPC will invoice DESC \$0.296 per liter. The Notice to Proceed was issued March 19, 2004, for 11 days; therefore, we estimated a POP from March 19 through March 29, or 11 days, and used the market price determined for the 15 day period of March 1 through March 15, 2004 for pricing the period of March 16 through March 31, 2004 in accordance with the Platts Pricing Index for the POP.

(b) Transportation

Our recommended transportation price of \$0.111 per liter is based on the current DESC subcontract with Altanmia for three round trips (turns) per month.

[REDACTED]
Our review disclosed that on May 4, 2003, KBR procured unleaded fuel including the subcontractor's additive factors and the fuel transportation. On May 8, 2003, the contractor rebid the transportation component [REDACTED]

Thus, the Kuwaiti supplier was relieved of the transportation component. The same Kuwaiti supplier subsequently won the transportation component less than a week later.

[REDACTED]

[REDACTED]

[REDACTED]

(c) Management & Oversight

DESC negotiated a contract for management and oversight to provide services to distribute the imported fuel to the Iraqi civilian populace. In computing an audit recommended price, we used the DESC contract rates as a benchmark for reasonableness.

Using the negotiated rates by DESC as a benchmark for reasonableness, we compared the proposed unleaded and diesel fuel and transportation costs to the current DESC contracts. We determined the proposed prices for unleaded gasoline and diesel and their transportation costs to be approximately [REDACTED] percent and [REDACTED] percent higher, respectively, than the DESC negotiated amounts. We believe these differences in prices are unreasonable. As a result, using the DESC negotiated prices adjusted by the Platt Pricing Index as a benchmark for reasonableness; we questioned the difference between the proposed fuel prices and the DESC negotiated prices as discussed above.

[REDACTED]

During our audit, we learned the COE waived KBR's requirement for submission of cost and pricing data on Contract No. DACA63-03-D-0005. The waiver from General Robert B. Flowers states,

"I have hereby determined that it is in the best interest of the United States Government to waive the requirement for cost and pricing data from Kellogg Brown and Root Services regarding its award of a subcontract for gasoline to Altanmia. By the authority delegated to me as the Head of the Contracting Agency, in accordance with FAR 15.403-1(c)(4), and upon reviewing the foregoing facts, authorities and analysis, I concur with the recommendation of my Contracting Officer and grant this Request for Waiver to Kellogg Brown and Root Services to exempt KBR from providing any cost and pricing data pertaining to its subcontract with Altanmia for the purchase of fuels under Task Orders 0005, 0007, and

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subsequent task orders involving the purchase of fuel under DACA63-03-D-0005."

On July 29, 2004, we issued a letter to the COE Director of Contracting requesting clarification on the waiver. Specifically, we requested clarification on whether a contracting officer determination had been made the costs proposed and incurred by KBR for Altanmia refined fuels and transportation are fair and reasonable. On August 3, 2004, COE Director of Contracting responded a DCAA audit was needed to assist in determining if KBR's proposed prices for Altanmia are fair and reasonable.

Our reading of the waiver does not relieve KBR of its responsibility to conduct a price analysis of the proposed Altanmia subcontract prices to demonstrate the reasonableness of the proposed subcontract prices. FAR 15.404-1(a)(2) states, "Price analysis shall be used when cost or pricing data are not required." FAR 15.404-3(b), Subcontract Pricing Considerations, states, "The prime contractor or subcontractor shall...Conduct appropriate cost or price analysis to establish reasonableness of the proposed subcontract prices." Despite the waiver granted by the COE, KBR states the fuel and transportation procurement is competitively priced [REDACTED]

[REDACTED] Our review of the documentation provided by KBR disclosed it had obtained vendor quotes on May 4, 2003 from three firms, with Altanmia being the lowest bidder. This information was communicated to the contracting officer who requested the Kuwait Oil Minister approve Altanmia as the subcontractor to provide fuel to Iraq. [REDACTED]

Additionally, in early May 2003, during a period of a few days, KBR obtained three supplier quotes and awarded a purchase order in the amount of [REDACTED] to Altanmia for unleaded fuel [REDACTED]

[REDACTED] Over the next several months, KBR made additional awards to Altanmia of over \$90 million for unleaded gasoline using the May 2003 price. [REDACTED]

[REDACTED] FAR 15.403-1(c) states,

(1) *Adequate price competition.* A price is based on adequate price competition if-

(i) Two or more responsible offerors, competing independently, submit priced offers that satisfy the Government's expressed requirement and if-

(A) Award will be made to the offeror whose proposal represents the best value (see 2.101) where price is a substantial factor in source selection; and

(B) There is no finding that the price of the otherwise successful offeror is unreasonable. Any finding that the price is unreasonable must be supported by a statement of the facts and approved at a level above the contracting officer;

(ii) There was a reasonable expectation, based on market research or other assessment, that two or more responsible offerors, competing independently, would submit priced offers in response to the solicitation's expressed requirement, even though only one offer is received from a responsible offeror and if-

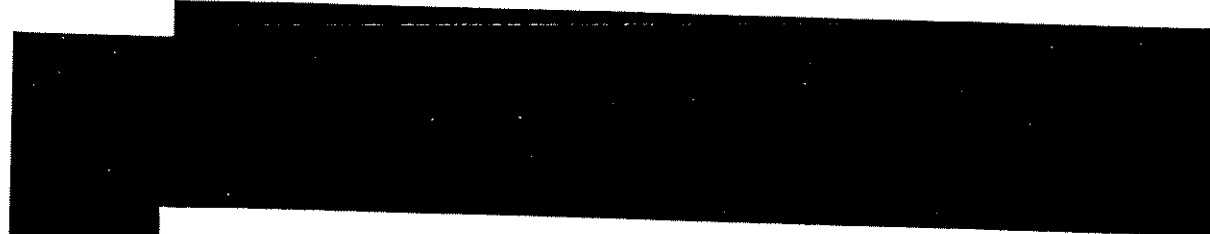
(A) Based on the offer received, the contracting officer can reasonably conclude that the offer was submitted with the expectation of competition, e.g., circumstances indicate that-

(1) The offeror believed that at least one other offeror was capable of submitting a meaningful offer; and

(2) The offeror had no reason to believe that other potential offerors did not intend to submit an offer; and

(B) The determination that the proposed price is based on adequate price competition, is reasonable, and is approved at a level above the contracting officer; or

(iii) Price analysis clearly demonstrates that the proposed price is reasonable in comparison with current or recent prices for the same or similar items, adjusted to reflect changes in market conditions, economic conditions, quantities, or terms and conditions under contracts that resulted from adequate price competition.



We believe the conditions surrounding the original procurement of Kuwaiti fuel under TO 5 (modified to extend to TO 7) changed substantially on January 25, 2004. We received a copy of a letter from KPC, dated January 25, 2004, addressed to a Procurement Manager for KBR. Based upon this letter, we understand KPC waived the requirement to negotiate directly with Altanmia upon the expiration of KBR's subcontract with Altanmia at the end of January 2004 due to the "recent uproar in the United States and Kuwait...regarding fuel overcharging." When asked why KBR did not subcontract with alternative vendors or renegotiate a lower price with Altanmia, the KBR Director of Government Compliance in a letter on June 3, 2004, stated the following:

"An informal suggestion was made by KPC, which did not include an offer with terms and conditions, was made on January 29, 2004, only days before the current contract was to expire on February 1, 2004. As a result, it would have been logistically impractical for KBR at that late date to have attempted to procure fuel directly from KPC. In contrast, KBR was under an existing contractual obligation with Altanmia for the provision of

fuel, and had every expectation that the contract would be extended (as had prior contracts over the course of the procurement).

In addition, KBR understands that, at that time, KPC was selling fuel to Altanmia at floating spot market prices. In contrast, Altanmia was supplying fuel to KBR based on a fixed per-liter price that, by January 2004, was lower than the floating spot-market fuel price that KPC was charging Altanmia. We understand that, in January 2004, Altanmia was paying KPC \$405 per ton for benzene (\$0.091 KD or \$0.303 per liter). These prices had risen steadily from \$325 per ton in September 2003 because of the rising spot market. On the other hand, KBR was purchasing fuel from Altanmia at a fixed price of \$0.09 KD (\$0.30) per liter. In addition, the floating price has continued to rise after January 2004 and by February 2004 had risen to \$407 per ton for benzene.

In addition, Altanmia was incurring administrative costs imposed by KPC of approximately \$20 per ton, which it could not pass on to KBR given the fixed-price nature of the fuel contract. Had KBR purchased fuel directly from KPC, it is likely that KBR would have incurred this additional administrative cost. Accordingly, it would not have been advantageous for KBR to have begun purchasing fuel from KPC on these terms.

Finally, with respect to transportation, Altanmia had amassed a substantial fleet of close to 1,900 trucks over the course of the previous fuel procurement. Given the overall shortage of trucks in Kuwait, KBR had no reason to believe that any other subcontractor could have begun to transport fuel beginning February 1, 2004, or had a realistic chance of meeting the USACE's fuel requirements."

KPC's letter to KBR releasing the requirement to contract only with Altanmia was dated, January 25, 2004. KBR had six days, from the date of the letter to the start of TO 8, to negotiate the procurement of fuel with KPC or alternate vendors. Rather than take advantage of these six days, KBR used basically the same purchase order prices negotiated in a short timeframe from nine months ago.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

KBR assumed no other subcontractor could amass a fleet of trucks as Altanmia had and it did not send out a request for proposals or contact any other subcontractors to determine if this was correct. Therefore, we are unable to determine if another subcontractor could have provided transportation services.

In summary, in our opinion, KBR had the opportunity after January 25, 2004 to renegotiate Kuwaiti fuel purchases but failed to act. Although the window of opportunity was short, there was enough time, as demonstrated in May 2003, when KBR made the initial award in a few days, to negotiate subcontracts with alternative vendors or renegotiate a lower price with Altanmia. As a result of KBR's failure to act in the purchase of Kuwaiti fuel when KPC waived the requirement to negotiate directly with Altanmia, the Government has paid unreasonable costs.

(2) Other Costs

We did not audit these costs due to immateriality.

(3) Subcontractor Claims & Demurrage Costs

We questioned [REDACTED] in subcontractor claims and demurrage costs, KBR did not provide the basis of estimate, including calculations for these proposed costs. KBR also did not provide a breakout of these costs between what was proposed as subcontractor claims or demurrage costs. Based upon concurrent audit activity conducted by our office, we have determined all of the demurrage costs incurred by KBR were incurred under TOs 5 and 7. We received an e-mail from [REDACTED], KBR Government Compliance, on June 23, 2004, stating only TOs 5 and 7, received demurrage costs. He also stated of the demurrage invoices, two had not been identified with a TO. When we reviewed these invoices, we found the invoices were dated in 2003, indicating they could only be charged to TOs 5 or 7, since those were the only TOs worked on in 2003. In addition, we believe subcontractor claim costs should not be included in a proposal. Since KBR has not been able identify or support proposed "subcontractor claims" costs, we question these costs as they represent contingencies which "should be excluded from cost estimates" in accordance with FAR 31.205-7 (c)(2).

d. Contractor's Reaction:

KBR did not provide any comments concerning factual matters during the exit conference. However, based on discussions and correspondence received during the audit, KBR does not concur with our position. Also, see the comments by the Director of Government Compliance starting on page 14 of this report.

6. Other Direct Costs (ODC)

a. Summary of Conclusions:

We questioned [REDACTED] of ODCs primarily due to KBR proposing demobilization costs when employees stayed in country to work on another contract, R&R hotel and airfare, when none should be allowed under KBR's employment agreements, and subcontractor DBA insurance because KBR did not provide any support and such costs would have been included in subcontractor estimates. Questioned costs are summarized as follows:

	Questioned Costs
Subcontractor DBA Insurance	[REDACTED]
R&R Costs	[REDACTED]
Demobilization Costs	[REDACTED]
Total	[REDACTED]

b. Basis of Contractor's Cost:

ODCs consist of costs for subcontractor DBA insurance, airfare and hotel costs associated with R&R, per diem costs for employees working in Kuwait, and cell phone charges. For DBA Insurance KBR stated the proposed rate of [REDACTED] percent is an error and the proposed rate should be [REDACTED] percent. KBR also proposed the same rate for its subcontractors.

c. Audit Evaluation:

We questioned [REDACTED] in subcontractor DBA insurance costs. Although DBA insurance is a requirement resulting from the Defense Base Insurance Act, we question these costs because (i) KBR did not provide any support for amounts proposed for subcontractors, and (ii) we would expect such costs would have already been included in subcontractor estimates. We requested support for the proposed subcontractor DBA insurance costs and KBR stated it did not have the subcontractors' insurance policies and did not provide any billings that indicated the subcontractors separately billed this cost to KBR. Since the DBA insurance is a requirement of the contract and absent any support to the contrary, it appears the proposed costs duplicate costs already included in negotiated subcontracts; therefore, we removed these costs from the proposal.

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We also questioned [REDACTED] in R&R airfare and hotel costs associated with the questioned R&R labor discussed in Note 2, page 7.

In addition, we questioned [REDACTED] in demobilization airfare and hotel costs. A KBR Projects Controls Manager stated the employees for the TO would stay in country and work on the W91296-04-D-0001, Iraq Infrastructure South Contract. Based upon this, the demobilization airfare and hotel costs proposed should be eliminated and proposed under the Iraq Infrastructure Contract.

d. Contractor's Reaction:

KBR did not provide any substantive information to incorporate into this audit report during the exit conference except for R&R costs as discussed in Note 2d on page 7.

e. Auditor's Response:

See Note 2e on page 7 regarding comments on R&R.

7. Overhead

a. Summary of Conclusions:

We questioned overhead costs of [REDACTED]. Questioned costs result from rate and base differences.

b. Basis of Contractor's Cost:

The contractor's overhead is computed by applying a proposed December 5, 2003, FPRR rate [REDACTED] percent to total direct costs.

c. Audit Evaluation:

We compared the proposed overhead rate to the current [REDACTED] FPRR rate of [REDACTED] percent. We computed the questioned overhead by applying the questioned [REDACTED] to the proposed base to determine questioned costs due to the questioned rate. We also applied the current FPRR rate to the questioned base costs to determine questioned costs due to questioned base costs.

Questioned costs are computed as follows.

Costs Questioned Due to Rate:

Proposed Base

Questioned Overhead Rate [REDACTED]

Questioned Overhead due to Questioned Rate [REDACTED]

Costs Questioned Due to Base:

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Questioned Base
Current FPRR Overhead Rate
Questioned Overhead due to Questioned Base

Total Questioned Overhead

d. Contractor's Reaction:

KBR acknowledged the use of the [REDACTED] FPRR should be updated to the [REDACTED] FPRR.

8. General & Administrative (G&A)

a. Summary of Conclusions:

We questioned G&A costs of [REDACTED]. Questioned costs result from rate and base differences.

b. Basis of Contractor's Cost:

The contractor's G&A is computed by applying a proposed [REDACTED] FPRR rate [REDACTED] percent to total direct and overhead costs.

c. Audit Evaluation:

We compared the proposed G&A rate from the December FPRR to the July 29, 2004 rate of [REDACTED] percent. We computed the questioned G&A by applying the questioned [REDACTED] percent to the proposed base costs (direct costs plus overhead) to determine questioned costs due to the questioned rate. We also applied the current FPRR rate to the questioned base costs to determine questioned costs due to questioned base.

Questioned costs are computed as follows:

Costs Questioned Due to Rate:

Proposed Base
Questioned G&A Rate (2.01% - 1.39%)
Questioned G&A due to Questioned Rate

Costs Questioned Due to Base:

Questioned Base
Current FPRR G&A Rate
Questioned G&A due to Questioned Base
Total Questioned G&A

d. Contractor's Reaction:

KBR acknowledged the use of the [REDACTED] FPRR should be updated to the [REDACTED] FPRR.

9. Facilities Capital Cost of Money (FCCM)

We compared the proposed FCCM rate to the FPRR dated [REDACTED] and took no exception.

Exit Conference:

We discussed factual matters concerning our findings with Ron Costello, Contracts; Nic Andrews, Government Compliance; Floyd Green, Government Compliance; and Ramesh Shah, Projects Contracts Manager; in an exit conference held on July 22, 2004. The factual matters discussed are detailed below.

- [REDACTED]
- KBR proposed kerosene costs after the ACO stop order was issued;
 - KBR did not provide support for the proposed subcontract claims and demurrage costs;
 - KBR did not provide supporting documentation for the subcontractor DBA insurance costs;
 - The proposal is not based on the current FPRR;
 - R&R costs were questioned in accordance with the RIO contract employee agreement; and
 - Labor rates changed due to payroll information given to DCAA;

We did not provide the dollar impact of our findings. KBR did not provide any comments concerning factual matters. However, even though comments were not provided in the exit conference except for R&R, we expect KBR to pursue the differences relating to fuel prices, R&R labor and ODC, subcontractor claims and demurrage cost, and subcontractor DBA insurance at negotiations. Because we expect the contractor to contest certain significant issues raised in our audit, we recommend you invite a DCAA representative to attend the negotiations conference.

CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

[REDACTED]

Based on the information we have, Halliburton's business is organized into two groups, the Engineering and Construction Group and the Energy Services Group (ESG). ESG includes four business segments - Drilling and Formation Evaluation, Fluids, Production Optimization, and Landmark and Other Energy Services. The Engineering and Construction Group (E&C) operates as KBR. This group provides engineering, procurement, construction, project management, facilities operation, and maintenance for oil and gas to industrial and Governmental customers.

In 2003 KBR transferred its U.S. Government contracts to Kellogg Brown & Root Services, Inc. (KBRSI), a division of KBR, and Halliburton provided a performance guarantee for the transferred contracts. KBRSI is responsible for performance of the Logistics Civil Augmentation Program (LOGCAP III), Restore Iraqi Oil (RIO) program, and Balkans support contracts. LOGCAP III with a ceiling of [REDACTED] provides contingency/wartime logistics support to military and civilian personnel for more than 80 locations worldwide. RIO consists of two contracts. One for the rebuilding of Iraqi oil infrastructure with a contract value of [REDACTED] and one for the restoration of southern Iraqi oil fields with a contract value of [REDACTED]. The Balkans support contract provides full logistic services to U.S. troops in the Balkans region. Halliburton has provided a corporate guarantee for the LOGCAP, RIO, and Balkans support contracts.

Halliburton revenues and personnel worldwide for prior fiscal years and projected revenues for FY 2004 are as follows:

	2004	2003	2002	2001
Total revenues (in millions)	[REDACTED]	\$16,271	\$12,572	\$13,046
U.S. Government sales	[REDACTED]	26%	<10%	<10%
Personnel	[REDACTED]	101,000	83,000	85,000

2. Systems

a. Accounting System:

[REDACTED]

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[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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b. Billing System:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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[REDACTED]

[REDACTED]

[REDACTED]

c. Estimating System:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

d. Purchasing System:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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[REDACTED]

[REDACTED]

[REDACTED]

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DCAA PERSONNEL

Primary contacts regarding this audit:

Stephanie M. Casey, Auditor
Gary R. Catt, Supervisory Auditor

Telephone No.

(303) 969-5000
(713) 753-2548

Other contact regarding this audit report:

William F. Daneke, Branch Manager

(817) 640-4948

Arlington Branch Office

FAX No.

(817) 633-4280

Arlington Branch Office

E-mail Address

dcaa-fao3318@dcaa.mil

General information on audit matters is available at <http://www.dcaa.mil>.

RELEVANT DATES

Request for Audit: PCO – dated and received March 30, 2004
Revised Due Date – July 16, 2004

AUDIT REPORT AUTHORIZED BY:

William F. Daneke
Branch Manager
DCAA Arlington Branch Office

/signed/

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DISTRIBUTION

Procuring Contracting Officer
US Army Corps of Engineers
Fort Worth District
ATTN: John Rogers
819 Taylor Street, Room 2A19
Fort Worth, Texas 76102

E-mail Address

john.h.rodgers@swf02.usace.army.mil
vernon.d.vann@swf02.usace.army.mil

US Army Corps of Engineers
Dallas District
ATTN: Gordon Sumner, Director of Contracting
1100 Commerce Street, Room 824
Dallas, Texas 75212

gordon.a.sumner@swd02.usace.army.mil

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